United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-2177

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN THE MATTER

OF

KINGSBORO MORTGAGE CORPORATION,

Bankrupt.

On Appeal from the United States District Court For the Southern District of New York

BRIEF OF APPELLEE BANKERS LIFE COMPANY

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Preliminary Statement

Appellants, who are a senior unsecured creditor of the bankrupt and the trustee in bankruptcy, appeal from an order of the United States District Court for the Southern District of New York, Honorable John M. Cannella, District Judge, presiding, disallowing the claims of senior unsecured creditors to post-petition interest. Appellee, the subordinated creditor next entitled to receive the return of its principal and pre-petition interest, had moved in the Bankruptcy Court for an order disallowing the claims of the senior unsecured creditors to post-petition interest on the ground that they had already received pay-

ment in full of the principal amount of the bankrupt's obligation to them with interest through the date of the filing of the petition in bankruptcy. The Bankruptcy Court denied appellee's motion, but the District Court reversed and held in appellee's favor.

Questions Presented

1. May the public policy underlying the Bankruptcy Act be ignored by granting senior creditors post-petition interest?

2. Under Section 63 of the Bankruptcy Act, 11 U.S.C. §103, may a creditor of a bankrupt file a claim for post-petition interest?

3. Under Section 63 of the Bankruptcy Act, 11 U.S.C. §103, may a creditor of a bankrupt receive post-petition interest on his claim if he has failed to file a claim for such post-petition interest?

4. May a contractual agreement among creditors, which is silent on the question of post-petition interest, be construed to grant senior unsecured creditors the right to such post-petition interest before subordinated creditors receive any of the principal amount of their claims?

Statement of the Case

The bankrupt herein, Kingsboro Mortgage Corporation ("Kingsboro"), was in the business of real estate mortgage financing (58a, 68a).* On January 13, 1969, Kings-

* Page numbers followed by "a" denote the page of the joint appendix on appeal.

boro filed a petition under Chapter XI of the Bankruptcy Act, 11 U.S.C. §701 *et seq.*, and it was adjudicated a bankrupt on February 26, 1969 (2a, 28a, 58a, 68a). Manufacturers Hanover Trust Company, Farm Bureau Life Insurance Company and Northwestern Life Insurance Company (collectively the "Senior Unsecured Creditors") filed claims against the bankrupt estate seeking payment of the unpaid principal balance of their notes and the interest due and owing thereon to the date of the filing of the petition in bankruptcy (36a-56a). Significantly, their claims did not seek interest beyond that date (36a-56a).

On or about February 19, 1969, appellee Bankers Life Company ("Bankers Life") filed a claim in the amount of $1,881,075 for the unpaid balance of principal and interest, to the date of bankruptcy, due on two 5¾% Subordinated Notes issued by Kingsboro (6a-8a). The Subordinated Notes were issued pursuant to an agreement, dated April 17, 1964, between Kingsboro and Bankers Life (12a-21a). Similarly, Kingsboro's other creditors, including several subordinate to Bankers Life, have also filed claims seeking the principal amount of their debt plus interest through the date of bankruptcy (3a, 23a, 59a).

On June 2, 1970, appellant Howard F. Sunshine, the trustee in bankruptcy (the "Trustee"), moved for an order subordinating Bankers Life's claim, as well as the claims of creditors subordinate to Bankers Life, to the claims of the Senior Unsecured Creditors (3a-4a, 59a, 68a). Although the trustee's motion originally requested subordination of these claims not only to the amount of the Senior Unsecured Creditors' claims to principal and interest through the date of bankruptcy but also to their alleged claim to post-petition interest, that motion was amended, pursuant to Bankers Life's request, to exclude for the time being post-petition interest (3a, 59a, 68a). Thereafter, and without any opposition from the various

creditors subordinate to the Senior Unsecured Creditors, the Bankruptcy Judge, Honorable Edward J. Ryan, ordered Bankers Life's claim, as well as the claims of other creditors who were subordinate to Bankers Life, subordinated to the Senior Unsecured Creditors' claims to unpaid principal and interest through the date of bankruptcy, without prejudice to the right of the Trustee to apply at a later time for an order subordinating those claims to the alleged claims of the Senior Unsecured Creditors to post-petition interest (22a-24a).

Since the date of bankruptcy, the Trustee had been disposing of the bankrupt estate and by early 1973 he had paid off approximately ninety percent of the Senior Unsecured Creditors' claims to principal and interest through the date of bankruptcy (60a, 68a). Furthermore, in early 1973 it appeared that the remaining assets of the bankrupt estate were insufficient to pay both Bankers Life's claim and the alleged claims of the Senior Unsecured Creditors to post-petition interest, not to mention the claims of creditors subordinate to Bankers Life (30a). Indeed, it appeared that if post-petition interest were paid to the Senior Unsecured Creditors, Bankers Life's recovery from the bankrupt estate would be substantially reduced and, perhaps, would be completely wiped out (30a).

On April 19, 1973, Bankers Life moved for an order disallowing the Senior Unsecured Creditors' alleged claims to post-petition interest or, in the alternative, subordinating them to Bankers Life's claim to principal and interest through the date of bankruptcy (1a). Appellants cross-moved for an order subordinating Bankers Life's claim and, thus, the claims of all creditors junior to Bankers Life to the claims of the Senior Unsecured Creditors to post-petition interest (26a-27a, 32a). On March 13, 1974, Bankruptcy Judge Ryan rendered a decision in which he

found, as a matter of law, that Bankers Life had agreed to subordinate itself to the Senior Unsecured Creditors' claims to post-petition interest (58a-63a). Accordingly, on March 25, 1974, an order was signed denying Bankers Life's motion, granting appellants' cross-motions and subordinating Bankers Life's claim to the claims of the Senior Unsecured Creditors to post-petition interest (64a-66a).

In due course, Bankers Life appealed to the United States District Court for the Southern District of New York. On July 31, 1974, the District Court, Honorable John M. Cannella presiding, reversed the order of the Bankruptcy Judge and held that the claims of the Senior Unsecured Creditors to post-petition interest were subordinated to Bankers Life's claim (67a-75a). *In re Kingsboro Mortgage Corp.*, 379 F. Supp. 227 (S.D.N.Y. 1974).

ARGUMENT

POINT I

The Senior Unsecured Creditors are not entitled to post-petition interest.

It has universally been recognized that the accrual of interest ceases as of the date of the filing of a petition in bankruptcy. 1A Collier Bankruptcy Manual ¶ 63.08 (1974).* The rule and the overriding public policy sup-

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* The only exceptions to this general rule occur (i) when the bankrupt estate later proves solvent or (ii) when securities held by a secured creditor as collateral produce interest during bankruptcy. *Sword Line, Inc.* v. *Industrial Commissioner*, 212 F. 2d 865 (2d Cir. 1954). Neither exception is relevant to the instant case, since the bankrupt estate is insolvent and the indebtedness involved is unsecured.

porting the rule were stated in *Vanston Bondholders Protective Committee* v. *Green,* 329 U.S. 156 (1946), as follows:

> "The general rule in bankruptcy and in equity receivership has been that interest on the debtors' obligations ceases to accrue at the beginning of proceedings. Exaction of interest, where the power of a debtor to pay even his contractual obligations is suspended by law, has been prohibited because it was considered in the nature of a penalty imposed because of delay in prompt payment—a delay necessitated by law if the courts are properly to preserve and protect the estate for the benefit of all interests involved." 329 U.S. at 163.

More recently the Supreme Court reiterated its position in *Nicholas* v. *United States,* 384 U.S. 678, 682 (1966), stating that:

> "We believe that the decisions of this Court in *Sexton* and *Saper* reflect the broad equitable principle that creditors should not be disadvantaged *vis-a-vis* one another by legal delays attributable solely to the time-consuming procedures inherent in the administration of the bankruptcy laws. In the context of interest-bearing debts, the equitable principle enunciated in *Sexton* and *Saper* rests at bottom on an awareness of the inequity that would result if, through the continuing accumulation of interest in the course of subsequent bankruptcy proceedings, obligations bearing relatively high rates of interest were permitted to absorb the assets of a bankrupt estate whose funds were already inadequate to pay the principal of the debts owed by the estate." 384 U.S. at 683-684.

See also, *New York* v. *Saper,* 336 U.S. 328, 330-332 (1949); *Sexton* v. *Dreyfus,* 219 U.S. 339, 344 (1911).

Courts in this Circuit have expressly followed the general rule. For example, in *Columbia Aircraft Company* v. *United States,* 163 F. Supp. 932 (S.D.N.Y. 1958) (L. Hand, Circuit Judge, sitting by designation), the court said:

> ". . . [T]here cannot be any doubt that in this circuit City of New York v. Saper, supra, 336 U.S. 328, 69 S. Ct. 554, 93 L. Ed. 710, is to be regarded as more than a decision as to the marshalling of the assets of a corporation in 'reorganization' or in an 'arrangement'; and as denying the survival of rights of any sort to post-bankruptcy interest". 163 F. Supp. at 934.

To allow the Senior Unsecured Creditors to recover post-petition interest in the case at bar would be to permit their interest claims "to absorb the assets of a bankrupt estate whose funds . . . [are] already inadequate to pay the principal of the debts owed by the estate." See, *Nicholas, supra,* at 684. Indeed, inasmuch as the Trustee has already taken more than five years to wind up the bankrupt estate, permitting the Senior Unsecured Creditors to obtain post-petition interest would, in all likelihood, consume the remainder of the estate and leave the subordinated creditors without any recovery whatever.

Put simply, the Senior Unsecured Creditors have received the benefit of their senior status by (1) receiving payment in full of all principal and interest to the date of the filing of the petition and (2) by receiving that payment considerably sooner than any payment to the subordinated creditors. To permit the Senior Unsecured Creditors also to collect post-petition interest would give them more than they bargained for and more than they are en-

titled to under Section 63 of the Bankruptcy Act, 11 U.S.C. §103, itself.

Section 63 embodies, in statutory form, the public policy enunciated in *Vanston, supra, Nicholas, supra* and *Columbia Aircraft, supra.* That section provides, in applicable part:

> "§ 63. *Debts Which May Be Proved.* a. Debts of the bankrupt may be proved and allowed against his estate which are founded upon (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition by or against him, whether then payable or not, *with any interest thereon which would have been recoverable at that date. . . .*" [Second emphasis supplied].

The language of Section 63 clearly says that a claim to post-petition interest is not provable against the bankrupt estate. The Supreme Court in *New York* v. *Saper, supra* at 331, said that "Section 63(a)(1), 11 U.S.C. § 103(a)(1) allows interest on . . . written instruments only to the date of bankruptcy. . . . No provison permits post-bankruptcy interest on other claims. . . ." Given the strong public policy underlying Section 63, as expressed in the authorities cited earlier in this brief, it is difficult to see how a creditor which has received its principal and pre-petition interest in full can seriously argue that it is entitled to enrich itself to the extent of post-petition interest while subordinated creditors go empty handed.

Courts will, of course, permit creditors to structure contractually the prioritiy of their various provable claims, as defined by Section 63 of the Bankruptcy Act, *In re Credit Industrial Corp.*, 366 F. 2d 402 (2d Cir. 1966), to the extent permitted by law. In *Credit Industrial,* the

subordinated creditors argued that the subordination agreement could not be enforced against them unless the senior creditors first established that they had relied on the agreement. This Court rejected that argument, holding that, within the requirements of and public policy underlying the Bankruptcy Act, creditors may contractually structure the priorities of their claims against the bankrupt estate. There is not the slightest suggestion in the *Credit Industrial* case that this Court was even considering post-petition interest or that the Court was adopting a rule for this Circuit contrary to that expressed by Judge Hand in *Columbia Aircraft Company* v. *United States, supra.* By not disputing the right of the Senior Unsecured Creditors to their principal and pre-petition interest, Bankers Life has completely honored its obligation to the Senior Unsecured Creditors under the subordination agreement.

Contrary to appellants' suggestion, no court has held that an agreement, which is silent on the question of post-petition interest, should nonetheless be construed to grant senior creditors such interest. In fact, the Third Circuit in *In re Time Sales Finance Corp.*, 491 F. 2d 841 (3d Cir. 1974) recently stated:

> "If a creditor desires to establish a right to post-petition interest and a concomitant reduction in the dividends due to subordinated creditors, the agreement should clearly show that the general rule that interest stops on the date of the filing of the petition is to be suspended, at least vis-a-vis these parties." 491 F. 2d at 844.

In the *Time Sales* case, the subordination agreement provided that:

> "In the event of any liquidation, dissolution or winding up of the company or of any receivership, insolvency, bankruptcy, liquidation, readjustment, reorganization or other similar proceedings relative to the company or its creditors or its property, *all principal and interest owing on all superior indebtedness of the company shall be paid in full before any payment is made on* [*the subordinated debt*]. . . ." (Emphasis by the court.) 491 F. 2d at 842.

Relying on this language, one of the senior creditors moved for an order subordinating the subordinated debt to its claim to post-petition interest. The Third Circuit affirmed the District Court's denial of that motion since the subordination agreement did not clearly apprise the subordinated creditors "that their claims against the bankrupt would be subordinated to . . . [the senior creditor's] demand for post-petition interest. . . ." 491 F. 2d at 844.

Significantly, the only alleged basis for the Senior Unsecured Creditors' claims to post-petition interest in the case at bar, and the basis of the decision of the Bankruptcy Judge, is found in Section 12(b) of the agreement of April 17, 1964 between Kingsboro and Bankers Life (17a-20a), a section so substantially similiar to the language of the subordination agreement in the *Time Sales* case as to be virtually indistinguishable from it. That section reads:

> "(b) In the event of any insolvency, bankruptcy, liquidation, reorganization or other similar proceedings, or any receivership proceedings in connection therewith, relative to the Company or its creditors or its property, and in the event of any proceedings for voluntary liquidation, dissolution or other winding up of the Company, whether or not involving

> insolvency or bankruptcy proceedings, then *all principal and interest on all Senior Debt shall first be paid in full, or such payment shall have been provided for, before any payment on account of principal or interest is made upon the Notes.*" (Emphasis supplied.)

As the court in *Time Sales* held, before such a clause can be construed to abrogate the general rule that interest cases to accrue with the filing of the petition, it must specifically provide for a different rule, which the clause in question palpably fails to do. Basic bankruptcy and equitable principles cannot and should not be abrogated by an indefinite reference to "all interest". Rather, as in *Time Sales,* such a provision must be regarded as nothing more than a reiteration of the general rule with the proviso that the Senior Unsecured Creditors have priority within the scope of general rule.

On December 5, 1974, the District Court in Colorado held that, in order to subordinate claims of junior creditors to senior creditors' claims to post-petition interest, the subordination agreement must clearly refer to post-petition interest. *In re King Resources Company,* Index No. 71-B-2921 (D. Colo. 1974).* In that case, a subordination agreement, which entitled senior creditors to "payment in full of the principal thereof (and premiums, if any) and interest due thereon" before subordinated creditors received any payment on their indebtedness, was held not to give the senior creditors the right to collect post-petition interest, either from the bankrupt estate or from the subordinated creditors themselves.

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* Bankers Life will supply appellants with copies of the court's decision in *King Resources* together with service of this brief and will hand a copy of that decision up to the Court on the argument of this motion.

Nothing in this Court's decision in *In re Credit Industrial, supra,* is in any way inconsistent with the Third Circuit's decision in *Time Sales* or with the court's decision in *King Resources* or with the District Court's decision in the case at bar. Instead, the latter three courts have simply held that the subordination agreements did not clearly and unambiguously provide for the payment of post-petition interest. Moreover, while none of these courts found it necessary to decide the statutory and larger public policy questions, clearly this Court's decision in *Credit Industrial* cannot be read to encompass agreements as to post-petition interest involving as they do claims which are not provable in bankruptcy and which are against public policy.

The public policy underlying the Bankruptcy Act is equality of distribution and rehabilitation of the bankrupt. All rights are, accordingly, fixed as of the date of bankruptcy and, as indicated above, should not be disturbed. This is particularly true where, as here, the alleged predicate for altering such rights is nothing more than a standard form agreement, an agreement obviously approved by the Senior Unsecured Creditors themselves (21a). Appellants' argument that Bankers Life should have required more unambiguous language in the agreement (App. Br. p. 12) ignores the realities of the situation. Since that provision was undoubtedly required and approved by the Senior Unsecured Creditors (21a) for their benefit, they should have sought clarity. Under these circumstances, this Court should follow the rationale expressed in all of the decided cases and hold that the priorities of the Senior Unsecured Creditors are fixed as of the date of the filing of the petition in bankruptcy and that Bankers Life and the creditors subordinated to it have not subordinated their claims to the alleged claims of Senior Unsecured Creditors to post-petition interest.

POINT II

The Senior Unsecured Creditors' claims are not claims against Bankers Life but are general unsecured claims against the bankrupt estate.

A bankruptcy proceeding is, of course, an *in rem* proceeding in which the touchstone is equality of distribution and in which the trustee is not empowered to exercise powers outside of the language of, and public policy underlying, the Bankruptcy Act. *See Local Loan Company* v. *Hunt,* 292 U.S. 234, 241 (1934); McLachlan on Bankruptcy, §§ 538, 301 (1956); 1 Collier Bankruptcy Manual ¶ 2.01[3] (1973); 1A Collier Bankruptcy Manual ¶ 65.00 (1974).

In an effort to avoid these fundamental principles, the clear language of Section 63 of the Bankruptcy Act, 11 U.S.C. §103, and the public policy evidenced by that section and by the long line of cases cited in Point I, *supra,* appellants seemingly contend that Section 63 does not apply to the Senior Unsecured Creditors' claims to post-petition interest because their claims are against Bankers Life and not against the bankrupt estate. Support for this argument is supposedly found in Section 12(d) of the agreement between Bankers Life and Kingsboro which provides that, in the event of the bankruptcy or insolvency of Kingsboro, distributions may be made directly to the Senior Unsecured Creditors of money or securities which would normally be made to Bankers Life "until all principal and interest on all Senior Debt shall have been paid in full or payment thereof in cash shall have been provided for. . . ." (18a-19a).

Section 12(d), however, merely provides a method for recognizing the priority to be given to the claims of the Senior Unsecured Creditors as provided in an earlier sec-

tion of the agreement, Section 12(b) (see pp. 10-11, *supra*), to which it expressly refers (18a-19a), and does not create substantive rights as appellants contend. The reference to "all principal and interest" in Section 12(d) is the same as in Section 12(b) and certainly does not contain any reference to post-petition interest. Furthermore, Section 12(d) also provides that the arrangement established therein:

> ". . . is subject to the power of a court of competent jurisdiction to make other equitable provision reflecting the rights conferred herein upon the Senior Debt and the holders thereof with respect to the subordinate Indebtedness represented by the Notes and the holders thereof by a lawful plan of reorganization under any applicable bankruptcy or reorganization law. . . ." (19a).

Thus, the arrangement established by Section 12(d) was expressly made subject to the underlying policy and express provisions of the Bankruptcy Act as well as the equitable powers of the Bankruptcy Court.

The arrangement established by Section 12(d) does not give the Senior Unsecured Creditors a claim against Bankers Life but rather gives them a right to receive distributions from the bankrupt estate which normally would be paid to Bankers Life. While the Senior Unsecured Creditors may have wanted a claim against Bankers Life, and could have easily attempted to articulate such a claim in Section 12(d), they did not do so, electing instead to have a claim only against the bankrupt estate. Section 12(d) and the substantive section to which it applies, Section 12(b), simply provide for the subordination of Bankers Life's claim to the claims of the Senior Unsecured Creditors to the unpaid principal and interest of their in-

debtedness as to which they would ordinarily be entitled under Section 63 of the Bankruptcy Act. The benefit which the Senior Unsecured Creditors bargained for and have now obtained was the right to have their claims in bankruptcy paid first. Having now obtained that bargained for objective, they are not entitled to obtain more. Appellants are unable to point to anything other than the reference to "all principal and interest," which gives the Senior Unsecured Creditors a claim to that added benefit. In rejecting this claim, the District Court, the Third Circuit in *Time Sales, supra,* and the court in *King Resources, supra,* have simply held that, before a subordination agreement will be construed to abrogate the general rule that interest ceases to accrue at the date of bankruptcy, that agreement must be clear and unambiguous. Since the agreement which the Senior Unsecured Creditors now rely upon is, as it states, designed for bankruptcy or insolvency proceedings, that agreement must be taken to incorporate Section 63 of the Bankruptcy Act and the many cases construing it, and the reference to "all principal and interest" must be presumed to mean all principal and interest to which they would be entitled in a bankruptcy context, that is unpaid principal and interest through the date of bankruptcy.

Furthermore, appellants' argument completely ignores the final paragraph of Section 12 of the April 17, 1964 agreement between Kingsboro and Bankers Life, the very section upon which their entire argument is based. That paragraph provides, in applicable part:

> "The provisions of this section 12 are for the purpose of defining the relative rights of the holders of Senior Debt on the one hand, and the holders of the Notes on the other hand, *against the company and its property. . . .*" (empasis supplied) (20a).

This paragraph makes it absolutely clear that Section 12 merely structures the priorities among creditors against the bankrupt estate and does not create rights between creditors or give the Senior Unsecured Creditors a claim against Bankers Life. The court in *King Resources, supra,* in the face of similar language, rejected the arguments of senior creditors that their claims to post-petition interest were really against the subordinated creditors.

This Court in *In re Credit Industrial, supra,* also correctly spoke of the contractual structure of the relative priority of claims against the *debtor* and not of the creation of claims by one class of creditors against another. Contractual subordination agreements do nothing more than "create priorities among debts," *In re Credit Industrial Corp., supra,* at 409, and do not create debts between one class of creditors and another.

Finally, since the effect of appellants' contention is much broader than to subordinate Bankers Life to the Senior Unsecured Creditors' claims to post-petition interest, consideration must be given to the rights of other creditors subordinate to Bankers Life who will likewise be adversely effected. The Senior Unsecured Creditors have never claimed that those other creditors agreed to be subordinated to the Senior Unsecured Creditors' claims to post-petition interest. Yet, that is the effect which will result if the appellants' contention is adopted by this Court.

CONCLUSION

The Court should affirm the decision and order of the District Court in its entirety.

Respectfully submitted,

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